
Yves Bonnard

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YVES BONNARD*

I. INTRODUCTION

On January 1, 1994, a new income tax treaty between the United States and the Netherlands entered into force.¹ The protocol amending the original version of the treaty provides special rules for a specific type of income: U.S.-source interest and royalties earned by a branch of a Dutch corporation located in a low-tax third country.² This situation is called the triangular case.³

Assume that a multinational corporation ("Dutch Co.") has its headquarters in the Netherlands and that its financial branch handles its investments in foreign subsidiaries. The financial branch is a permanent establishment⁴ located in Zug, a low-tax canton (state) in Switzerland. This branch is also responsible for the licensing of patent rights owned by Dutch Co. to manufacturing divisions. All interest and royalty income of Dutch Co. is centralized in its financial branch. A subsidiary of Dutch Co., Ameri Co., is a U.S. corporation that pays interest and royalties to the Swiss financial branch.

* Associate with Baker & McKenzie in Geneva, admitted in Switzerland; LL.M. in Taxation, University of Denver, 1994. The author gratefully acknowledges the review of earlier drafts of this article by John R. Wilson, adjunct Professor of Taxation at the Graduate Tax Program of the University of Denver College of Law.


3. The term triangular case involves different problems. This study is limited to the U.S. concerns about tax avoidance in triangular cases as recently developed in the Protocol to the U.S. - Netherlands Income Tax Treaty. See generally OECD Commentary on Model Income Tax Treaty, art. 24, notes 51-54; ORGANIZATION FOR ECONOMIC COOPERATION & DEVELOPMENT, MODEL TAX CONVENTION: FOUR RELATED STUDIES (Paris 1992) (on file with author); PHILIP BAKER, DOUBLE TAXATION CONVENTIONS AND INTERNATIONAL TAX LAW 396 (2d ed. 1994).

4. For a definition of permanent establishment, see OECD Model Income Tax Treaty, art. 5, reprinted in BAKER, supra note 3, at 140-42 [hereinafter OECD Model].
Without any tax treaty or internal law provision, the interest and royalties paid by Ameri Co. and earned by Dutch Co. could incur tax liability in three countries: (1) The United States, where the interest and royalties are paid, could impose its 30% withholding tax; 5 (2) The Netherlands, where Dutch Co. is incorporated, could tax this income as a part of Dutch Co.'s world-wide taxable income; and (3) Switzerland, where the interest and royalties are actually earned, could tax the income of Dutch Co.'s branch as a Swiss permanent establishment. 6

As a relief from double taxation, the Netherlands applies the exemption method. 7 Under this method, foreign income is tax free in the taxpayer's Country of Residence, or home country, whether the foreign country (the Country of Source 8) taxes the income or not. Applying the exemption method, the Netherlands does not tax the income earned by Dutch Co. in Zug through its Swiss branch.

The Convention reduces the U.S. withholding tax on interest to 5 or 15 percent and eliminates the tax on royalties. 9 By definition, a branch does not constitute a separate entity, so the financial branch of Dutch Co. can take advantage of the U.S.-Netherlands tax treaty even though it is located in Switzerland, a third country. Finally, the branch pays few taxes in Zug, which is a low-tax state.

As a result, instead of incurring taxes in three different countries, the interest and royalties paid by Ameri Co. to the Swiss branch of Dutch Co. are actually subject to very little tax: a reduced withholding tax on interest in the United States and a low income tax in Zug.

In order to prevent such tax avoidance, the Protocol provides for a flat 15 percent U.S. withholding tax on interest and royalties earned by a foreign branch of a Dutch corporation from sources within the U.S. if the aggregate tax rate imposed on such earnings in the Nether-

6. OECD Model, supra note 4.
7. The United States uses the tax credit method, which consists of subtracting the tax paid in the Country of Source from the home country tax liability.
8. Under its Decree for the Prevention of Double Taxation, the Netherlands applies a method called proportional tax exemption. See generally Kees van Raad, Business Operations in The Netherlands, 150 Tax Mgmt. 150-5th (1989) (describing the proportional tax exemption method). Relief from double taxation occurs when the taxpayer qualifies for the proportional tax exemption.
   In order to qualify for the proportional tax exemption, the foreign income must be subject to an income tax in the country from which the income is derived . . . . Furthermore, it is required only that the income is taxable under the foreign income tax law; not that foreign tax is imposed and paid. Consequently, if no foreign income tax is paid as a result of, e.g., loss compensation and tax fraud, this does not affect the application of the exemption.
   Id. at A-47.
9. Convention, supra note 1, art. 12 (for interest), art. 13 (for royalties), at 472-73.
lands and in the third country does not equal at least 50 percent (60 percent after January 1, 1998) of the regular Dutch corporation tax rate.  

The international tax policy of the United States will not allow a Dutch corporation the benefit of the Convention if the interest and royalties from U.S. sources are either tax free or subject to low tax rates. The United States will probably extend this policy to other U.S. treaty partners that use the exemption method as a relief from double taxation. In 1992, the House of Representatives discussed, though never adopted, provisions similar to the Protocol.  

As shown below, these provisions would have superseded all existing U.S. treaties signed with “exemption-tradition” treaty partners. The underlying cause of this new policy is clear: the United States is concerned that the execution of a treaty with an “exemption-tradition” country may create too many tax havens for interest and royalties.

The provisions of the Protocol generate as many problems as they solve. This article begins by describing the distinction between the exemption and the tax credit methods and the mechanics of the Protocol itself. The article then addresses the following questions: (1) If the Country of Residence applies the “exemption with progression” method in order to avoid double taxation, should the increased tax liability in this country be taken into account in determining the minimum required aggregate rate of tax?; (2) What are the repercussions of an income tax treaty between the U.S. and a third country on the flat 15 percent withholding tax?; (3) Will the U.S. impose this kind of provision on other treaty countries, such as Switzerland, that also apply the exemption method as a relief from double taxation?; (4) If so, will this change occur through treaty negotiations or by enactment of internal provisions that would override existing treaties?; (5) Do these provisions represent an invasion of the treaty country’s internal law beyond the scope of an income tax treaty?; and finally, (6) What are the consequences for such treaty countries and for their corporations?

II. EXEMPTION: RELIEF FROM DOUBLE TAXATION
A. Relief From Double Taxation

International double taxation typically occurs when the same person is liable for tax in two different jurisdictions on the same item of income. The Country of Source, also called the host country, taxes

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the income generated within its boundaries based on a territorial connection with the source of the income. The Country of Residence, based on a personal connection with the recipient, taxes its residents on their world-wide income.

In order to alleviate the burden of double taxation, one of the countries must renounce taxing the income. It is generally recognized that the Country of Residence must provide relief from double taxation and, consequently, the Country of Source has the taxing priority, a principle that Edrey and Jeffrey call “first bite to the host country.”

Whether by internal law provisions or by treaty, relief from double taxation occurs in one of two methods: (1) the exemption method, or (2) the tax credit method. The latter, introduced in the United States in 1918, consists of subtracting from the tax liability in the Country of Residence all or part of the taxes paid abroad. The full credit method credits all taxes paid in a foreign country against the tax due in the Country of Residence. The ordinary credit method limits the tax liability reduction by the amount of tax that would have been paid in the Country of Residence. Most traditional tax credit countries, including the United States, use this method.

Under the exemption method, the income earned in the Country of Source is tax free in the Country of Residence. Like the tax credit method, the exemption method may actually provide tax relief in two different ways: (1) full exemption, and (2) exemption with progression. The latter does not completely disregard the income earned in the Country of Source because the taxpayer’s overall income determines the applicable tax rate in the Country of Residence.

The following example compares both methods of exemption with the ordinary tax credit method: Assume a taxpayer has a total income of $200,000, one half earned in the Country of Residence and the other half in the Country of Source. The tax rate in the Country of Residence is 30% for an income of $100,000 and 40% for an income of $200,000. Regardless of which tax rate the Country of Source applies, three inferences may be drawn on the tax liability incurred in the Country of Residence depending upon the method used to avoid double taxation. First, if the Country of Residence applies the ordinary credit method, the maximum amount of credit against the taxpayer’s tax liability in the Country of Residence equals the tax that would have been paid in that country, 40% x $100,000 = $40,000 (example 3.1 below). If the applicable tax rate is 50% in the Country of Source, the $50,000 tax paid in the Country of Source cannot be used in full against the tax liability incurred in the Country of Residence. Second, if the Country of Residence applies the exemption with progression method, the tax-

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payer computes it's liability in the Country of Residence with the tax rate corresponding to a $200,000 income even though only the Country of Residence on taxes $100,000 earned in that country, 40% x $100,000 = 40,000 (parts 1.2, 2.2, and 3.2 below). Third, if the Country of Residence applies the full exemption method, the taxpayer's liability in the Country of Residence equals 30% x $100,000 = $30,000 (parts 1.3, 2.3, and 3.3 below). Assuming, in succession, the applicable tax rate in the Country of Source equals 0%, 10%, and 50%, the effect on the taxpayer's total tax liability (tax paid in the Country of Source (CS)) and tax paid in the Country of Residence (CR) is computed as follows:

1. Country of Source tax rate equals 0%

1.1 CR applies the ordinary credit method

<table>
<thead>
<tr>
<th>Tax Liability</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tentative tax liability in CR</td>
<td>$200,000 x 40% = $80,000</td>
</tr>
<tr>
<td>Less tax paid in CS</td>
<td>$0</td>
</tr>
<tr>
<td>Tax liability in CR</td>
<td>$80,000</td>
</tr>
<tr>
<td>Total tax liability</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

1.2 CR applies the exemption with progression method

<table>
<thead>
<tr>
<th>CR tax liability</th>
<th>Tax liability in CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>CR tax liability</td>
<td>$40,000</td>
</tr>
<tr>
<td>Plus CS tax liability</td>
<td>$0</td>
</tr>
<tr>
<td>Total tax liability</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

1.3 CR applies the full exemption method

<table>
<thead>
<tr>
<th>CR tax liability</th>
<th>Tax liability in CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>CR tax liability</td>
<td>$30,000</td>
</tr>
<tr>
<td>Plus CS tax liability</td>
<td>$0</td>
</tr>
<tr>
<td>Total tax liability</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

2. CS tax rate equals 10%

2.1 CR applies the ordinary credit method

<table>
<thead>
<tr>
<th>Tax Liability</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tentative tax liability in CR</td>
<td>$20,000 x 40% = $80,000</td>
</tr>
<tr>
<td>Less tax paid in CS</td>
<td>$&lt;10,000&gt;</td>
</tr>
<tr>
<td>Tax liability in CR</td>
<td>$70,000</td>
</tr>
<tr>
<td>Total tax liability</td>
<td>$10,000 + $70,000 = $80,000</td>
</tr>
</tbody>
</table>

2.2 CR applies the exemption with progression method

<table>
<thead>
<tr>
<th>CR tax liability</th>
<th>Tax liability in CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>CR tax liability</td>
<td>$40,000</td>
</tr>
<tr>
<td>Plus CS tax liability</td>
<td>$10,000</td>
</tr>
<tr>
<td>Total tax liability</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

2.3 CR applies the full exemption method

<table>
<thead>
<tr>
<th>CR tax liability</th>
<th>Tax liability in CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>CR tax liability</td>
<td>$30,000</td>
</tr>
<tr>
<td>Plus CS tax liability</td>
<td>$10,000</td>
</tr>
<tr>
<td>Total tax liability</td>
<td>$40,000</td>
</tr>
</tbody>
</table>
3. CS tax rate equals 50%

3.1 CR applies the ordinary credit method
   Tentative tax liability in CR  200,000 x 40% = 80,000
   Less tax paid in CS 50,000 but limited to <40,000>
   Tax liability in CR  40,000
   Total tax liability  50,000 + 40,000 = 90,000

3.2 CR applies the exemption with progression method
   CR tax liability  40,000
   Plus CS tax liability  50,000
   Total tax liability ........................... 90,000

3.3 CR applies the full exemption method
   CR tax liability  30,000
   Plus CS tax liability  50,000
   Total tax liability ........................... 80,000

As demonstrated in parts 1 and 2 of this example, the taxpayer’s total tax liability is lower if the Country of Residence applies one of the exemption methods rather than the ordinary tax credit method. The exemption method provides an incentive for foreign investments in low-tax rate countries. These examples will be discussed in greater detail later.

15. As one observer has stated, the foreign tax credit limitation can be considered to detract from economic efficiency, because the inability to credit excess foreign taxes against U.S. tax on U.S. source income can result in a greater overall tax burden for foreign than for domestic investment (where foreign taxes
detail below.

B. Use Of The Exemption Method In Developed Countries

Under the OECD Model Income Tax Treaty, member states have the choice between the exemption with progression method and the ordinary credit method.16 Neither the full exemption method nor the full credit method is available.

In the European Union (EU), most member-states use a combination of both methods. “[States use] the exemption method for some types of foreign-source income such as dividends from a substantially owned subsidiary, or branch profits, and the credit method for some other types of foreign-source of income such as interest and royalties.”17

Switzerland is not a member of the EU but also uses a combination of both methods. Even absent any international convention, Switzerland applies the exemption with progression method for income earned by a resident through a foreign permanent establishment.18

III. MECHANISM OF THE NEW U.S.-NETHERLANDS PROTOCOL AND RELATED PROBLEMS

A. Premise

The Foreign Income Tax Rationalization and Simplification Act Of 1992,19 introduced before the Congress but never seriously considered for passage, included a section on treaty abuse. The bill would have amended I.R.C. §894 as follows:

paid exceed the U.S. tax). Restrictions on cross-crediting are often considered to impair competitiveness by subjecting U.S. investors to a greater overall tax burden than their foreign competitors that benefit from an exemption of their source income or from greater cross-crediting opportunities.


16. OECD Model, art. 23A (permitting the exemption with progression method) and 23B (permitting the ordinary credit method), supra note 4, at 364-65; ORGANIZATION OF ECONOMIC COOPERATION AND DEVELOPMENT, Modèle de Convention Fiscale: Attribution de Revenus aux Etablissements Stables, reprinted in QUESTIONS DE FISCALITÉ INTERNATIONALE NO.5, at 10 (1994) (Germany, Austria, Belgium, France, the Netherlands, and Switzerland are some of the OECD members using the exemption method).


19. H.R. 5270, supra note 11.
(c) Limitation On Treaty Benefits.

(2) Tax Favored Income. No person shall be entitled to any benefits granted by the United States under any treaty between the United States and a foreign country with respect to any income of such person if such income bears a significantly lower tax under the laws of such foreign country than similar income arising from sources within such foreign country derived by residents of such foreign country.20

The proposed I.R.C. §894(c)(2) stated that notwithstanding any treaty provision under which the U.S. had agreed to exempt U.S. source income, such as interest, from withholding tax, the U.S. could still impose a tax if the treaty partner (the Country of Residence), Switzerland for example, did not tax this interest or taxed it at a substantially lower rate. In order to determine whether the rate applicable to U.S. source interest is “significantly lower,” it must be compared with the regular Swiss rate applicable to interest from sources within Switzerland.

Practically speaking, as long as a taxpayer of the Country of Residence earns the interest income, there is no reason the foreign source interest income should be taxed at a lower rate than domestic source interest income. If the Country of Residence, like Switzerland, uses the exemption method to avoid double taxation, foreign source interest income may be subject to a lower tax rate than domestic source foreign income.

Hence, House Bill 5270 focuses on the triangular case and attempts to eliminate this result. The technical explanation of the bill confirms this.21 The explanation provides that if a corporation is a resident of a U.S. treaty partner and has a branch in a tax haven (hereinafter Third Country), and the Country of Residence uses the exemption method to avoid double taxation, then any income from sources within the U.S. earned by the branch may incur a low tax liability or may not incur any tax liability. For example, the branch would not have any tax liability in the U.S. because the branch is not a separate entity and is a resident of the treaty partner and a beneficiary of the income tax treaty between the U.S. and the Country of Residence. In addition, there would be no tax liability in the Country of Residence because this country, using the exemption method, disregards foreign earnings of its residents. Finally, the Third Country may impose a low tax rate or not impose a tax rate on the corporation. In such a situation, H.R. 5270 would have reserved the right of the U.S. to withhold the regular tax on such income as if there was no treaty in place. The scope of this provision was broad. It did not relate to a spe-


cific type of income from sources within the U.S., it did not recognize an exemption if a tax had to be paid in the Third Country by the branch, and it did not consider the possibility of an income tax treaty between the U.S. and the Third Country.

B. The Protocol

The Protocol signed in October 1993 with the Netherlands is an improvement over the rigid H.R. 5270. Article 24, paragraph 4 of the Convention provided that if the Netherlands had not enacted internal anti-tax-haven rules prior to the Convention's introduction before the U.S. Senate Foreign Relations Committee, then rules serving the same goal would be added to the treaty through bilateral provisions to be signed by both countries. In July 1993, the Netherlands Finance Ministry released an anti-tax-haven draft bill that was still subject to debate in Fall 1993.\(^{22}\) In order to accelerate the ratification of the treaty, negotiators from both countries signed the Protocol on October 13, 1993.

The Protocol adds two similar paragraphs to Articles 12 and 13 of the Convention relating to interest and royalties respectively.\(^ {23}\) The Protocol creates an exception to the general rule, found in Articles 12 and 13, giving exclusive competence of taxation to the Country of Residence. The Country of Source can withhold a 15% tax if the following conditions are met: (1) Interest and royalties arising in the Country of Source are not directly attributable to the enterprise in the Country of Residence; (2) The interest and royalties are attributable to a permanent establishment of that enterprise located in a Third Country; and (3) The "aggregate rate of tax" imposed in both the Country of Residence and the Third Country is less than 50% of the income tax rate applicable to an enterprise in the Country of Residence (60% for interest and royalties due after January 1, 1998).

Nevertheless, no tax may be withheld for interest earned by the permanent establishment in connection with, or incidental to, the active conduct of a trade or business.\(^ {24}\) Banking and insurance activities can benefit from the active trade or business exception, even if the income derives from related party financing or portfolio investment.\(^ {25}\)


\(^{23}\) Convention, supra note 1, art. 12, para. 6, at 473 (relating to interest); art. 13, para. 5, at 474 (relating to royalties).

\(^{24}\) Convention, supra note 1, art. 12, para. 3, at 472.

Also, taxes may not be withheld for royalties received as a compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself in the Third Country (i.e. sharing the costs of development that are not undertaken in the Third Country does not prevent withholding tax by the Country of Source). 

A parallel may clearly be drawn between these provisions and general U.S. tax policy. Under I.R.C. § 871(h) and § 881(c), portfolio interest usually is exempt from withholding tax unless the payment occurs between related parties. Financing arrangements between related parties are also the target of I.R.C. § 163(j), which is an "earnings stripping" provision that limits the deduction of interest paid to a related person.

C. Liminal Comment: The Definite Parameters

There are numerous defined parameters to the triangular case. First, the fact that the Dutch resident corporation qualifies under the Limitation on Benefits, stated at Article 26 of the Convention, is an axiom in this triangular case. Second, because the United States does not use the exemption method in order to avoid double taxation, the provisions introduced by the Protocol, even if they seem reciprocal, apply only to permanent establishments of Dutch corporations and not to permanent establishments of U.S. corporations. Third, the base of taxation of the income that may be subject to U.S. withholding tax is the global interest and royalties from sources within the U.S. even if the Netherlands taxes part of this income in applying a partial exemption rather than a total exemption. The example used by the Treasury to illustrate this rule is the Netherlands-Swiss income tax treaty under which 10% of a Dutch branch's income in Switzerland is usually "attributed" to the Dutch corporation and included in its gross income. In such a case, it is not only the 10% of Swiss interest and


27. See generally BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION, para. 66.2.2 (1991) (discussing "portfolio interest").


29. Treasury Explanation, supra note 25, art. 12, at 212-11.

30. See Convention entre la Confédération suisse et le Royaume des Pays-Bas en vue d'éviter les doubles impositions dans le domaine des impôts sur le revenu et sur la fortune, Jan. 9, 1952, Switz.-Neth., art. 4, para. 6 (Swiss reference RS
royalties income taxed in the Netherlands may be subject to the U.S. flat 15% tax as well as the full branch interest and royalties income from sources within the U.S. Fourth, the U.S. withholding tax has a flat 15% rate, no matter how close the taxpayer is with its "aggregate rate of tax" from the 50% (respectively 60% from 1998) of the "general" Dutch tax rate.

D. The Undefined Parameters

U.S. withholding may occur if the profits of that permanent establishment are subject to an aggregate rate of tax less than 50% of the general rate of the company tax applicable in the other State [Netherlands]. Three elements need to be determined: (1) the profits of the permanent establishment; (2) the aggregate rate of tax; and (3) the general Dutch tax rate applicable to the company.

E. The "Profits" of the Permanent Establishment

Our guideline in the present analysis is the Protocol's underlying anti-tax haven goal. The U.S. reserved the right to tax the branch's income if the tax rate in the Third Country is low in comparison with the Dutch rate. A tax rate may be low for a "political" or "objective" reason, because the jurisdiction does not want to tax a specific type of income, no matter how important this income is, or for an "economical" or "subjective" reason, because the taxpayer has a low taxable income. The Protocol purpose is to tax income that is subject to an "objective" low tax rate.

In order to gauge the tax rate, the income taken into consideration cannot be lowered by deductions or losses unrelated to business activities. If all types of income earned by the permanent establishment had to be taken into account in order to meet the definition of "business profit," as described in the U.S. Model Income Tax Treaty, the determination of the applicable tax rate would be necessarily "subjective" because it is influenced by the economic results of the other activities of the permanent establishment. The term "profit" of the permanent establishment must be understood as the profit resulting from interest and royalties from sources within the U.S.

F. The "Aggregate Rate of Tax"

Under the Treasury Explanation, the aggregate tax rate must be computed by adding the tax paid in the Third Country to the tax paid in the Netherlands. The aggregate rate is the ratio of the taxes paid
in both countries over the profits of the permanent establishment.\textsuperscript{33}

The tax paid is typically a subjective criterion to gauge a tax rate and does not serve the goal of the new U.S. policy. A literal application of the Treasury Explanation is possible only if the branch has no extra activities. If it does have other activities, then the Explanation must be interpreted and "tax paid" on branch profits must be understood as "tax payable" on the branch profits limited to U.S. interest and royalties without external activity deductions.

In the Netherlands, or any country applying the exemption with progression method,\textsuperscript{34} another question arises in determining the tax payable on the branch's profits. The following analysis assumes the branch has no income other than U.S. interest and royalties, but the same question arises if the permanent establishment has other sources of income.

As shown in the comparison between the tax exemption and tax credit methods, if the Country of Residence applies the exemption with progression method, the taxpayer's income in the Country of Source is not completely disregarded because it increases the tax rate in the Country of Residence. In example 1, had the taxpayer earned only $100,000 entirely sourced in the Country of Residence, the applicable tax rate would be 30%, and its tax liability would be $30,000; but, because he also earned $100,000 in the Country of Source and has a world-wide income of $200,000, the applicable rate is 40%, and his tax liability equals $40,000 (example 1.2). The exemption with progression method creates an increase in tax liability of $10,000.

In a full exemption context, the taxpayer's liability would remain $30,000 (example 1.3). On the other hand, in a tax credit context, the increase in tax liability would be $50,000 (tax liability in the Country of Residence (example 1.1) less $30,000). The exemption with progression intentionally has a "side effect" on the taxpayer's liability. The $100,000 income earned in the Country of Source is objectively tax free, but subjectively it generated a $10,000 tax increment out of $200,000 taxable income, corresponding to a 5% tax rate.

The Protocol does not seem to include this increase in tax liability in the computation of the "aggregate tax rate," and the Treasury Explanation is clear: The "aggregate tax rate" is the sum of the tax paid in the third jurisdiction plus "any Netherlands tax paid by the profits" of the permanent establishment;\textsuperscript{35} it does not say "any Netherlands tax paid as a result of the profits." The tax paid in the Country of Residence as a "side effect" of the exemption method with progression

\textsuperscript{33} See also Senate Committee Report, supra note 26, art. 12.

\textsuperscript{34} OECD Model, supra note 4, art. 23A, at 364-65 (stating all State Members using the exemption method should apply the exemption with progression).

\textsuperscript{35} Treasury Explanation, supra note 25.
must be ignored in the computation. This can be fatal to a taxpayer who might still qualify for the U.S. withholding in some situations, such as where the tax rate in the Country of Source is almost 50% of the one applicable in the Country of Residence.

If the U.S. position is intransigent, its consequences must be appreciated in different contexts. The "side effect" of exemption with progression does not occur in two situations: first, if the taxpayer is already subject to the maximum taxable rate in the Country of Residence before taking into account the income earned through the branch in the Country of Source; second, if the taxpayer has no income in the Country of Residence, and there is no tax base to be taxed, even at a higher tax rate.

Finally, it is surprising that the "aggregate rate" of tax does not seem to take into account any potential U.S. tax, even though such tax may be imposed when the Dutch corporation is a controlled foreign corporation (CFC).36 This question arose in a letter sent on November 10, 1993 by practitioners to the Assistant Secretary of the Treasury for Tax Policy.37

G. The "General" Dutch Rate of the Company Tax

The question arises whether the income earned by the branch has to be taken into account in determining the applicable Dutch tax rate. The temptation would be to deny the inclusion in order to lower the corporation's income and, consequently, the applicable rate in the Netherlands. However, the analysis must be consistent, and because the Netherlands applies the exemption with progression method, the applicable Dutch tax rate takes into account the income earned in the Third Country.

H. Repercussions of a Tax Treaty Between the U.S. and the Third Country

The Treasury Explanation illustrates the U.S. withholding tax mechanism assuming that the Swiss branch of a Dutch corporation lends funds to related parties in the U.S., and the aggregate Dutch and Swiss rate is below the applicable threshold. The Treasury concludes that "the U.S. source interest generated by those loans will be subject to a withholding tax of 15%, instead of the exemption provided in paragraph 1 . . . ."38 However, Article VII of the Swiss-U.S. income tax treaty39 limits the withholding tax rate to 5%, and Article VIII
gives a full exemption for royalties in the Country of Source.

Under which principle could the U.S.-Netherlands Convention influence the Swiss one? The new Dutch Convention is res inter alios acta, and the relationship between the U.S. and its treaty partners cannot be influenced by subsequent U.S. treaties. Furthermore, there is no treaty override principle between U.S. treaties. Only U.S. domestic legislation can override U.S. international commitments. Finally, the I.R.S. has ruled that in a case where two treaties would apply, the taxpayer may choose the more favorable.

The new Dutch Convention does not allow the United States to disregard any prior conventions. In the aforementioned Treasury example, if interest income from an United States source earned by a Swiss branch qualifies for U.S. withholding under the Dutch Convention, then the withholding rate is limited to 5%. Had the Swiss branch earned royalties, U.S. withholding would be prohibited.

It should be emphasized that this conflict between U.S. tax treaties will arise quite rarely because the U.S. does not sign tax treaties with low-tax countries. The Swiss case is peculiar because only some of the 26 Swiss Cantons (States) have low corporation tax rates.

I. Final Comments on the Mechanism

For Dutch corporations trading with the U.S. through a branch in a third country, the Protocol is an improvement over H.R. 5270. First, an "aggregate tax rate" is considered — as opposed to H.R. 5270, which only considered the Dutch rate — so Dutch corporations face U.S. withholding tax only if their branch is a tax-haven resident. Furthermore, only interest and royalties from U.S. sources are affected by the Protocol.

The U.S. may intend to extend this new treaty policy to other treaty partners. These countries, in negotiations with the U.S., should take the possibility of enactment of legislation similar to H.R. 5270 into account. Such legislation would override the present treaty and could be worse than negotiated provisions similar to the Dutch Protocol.

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IV. POTENTIAL DEVELOPMENTS OF THE NEW U.S. TAX TREATY POLICY: TREATY OVERRIDE V. BILATERAL PROVISIONS

“A treaty override occurs when an act of Congress overturns or modifies a tax benefit granted to foreign investors by a tax treaty.”42 Two different authorities share the competence of enacting international tax provisions: (1) Congress may modify the Internal Revenue Code, and (2) the Department of the Treasury and the Senate may enter into an international treaty. Under the interpretation of the Constitution by the Supreme Court, when conflicts between the two different sources of law arise, the later provision in time prevails.43

Relying on this rule, Congress may be tempted to unilaterally enact a provision in the Code that would have effects similar to the recent Dutch Protocol, rather than enter into difficult negotiations with U.S. treaty partners. This was actually one of the purposes of H.R. 5270.44

The advantage of a treaty override procedure, from the United States point of view, is the efficiency and the rapidity of enactment. For example, a new U.S.-Switzerland income tax treaty has been in negotiation for fourteen years and is not yet enacted, but only seven months were necessary to prepare and enact the Revenue Reconciliation Act of 1993.

This procedure, however, places the United States in a delicate position with its treaty partners regarding its obligations under international law.45 In the H.R. 5270 case, the reaction was immediate. Barely two months after the introduction of the bill before the Congress, the ambassadors of eighteen OECD member countries protested and claimed that such a provision “would be likely to lead to strong pressures on their [our] governments to introduce retaliatory measures.”46

42. See generally Gourevitch, supra note 40 (discussing treaty overrides).
43. RESTATEMENT (THIRD) OF THE FOREIGN RELATION LAW OF THE UNITED STATES §115(1)(a) (1986) states that
[a]n Act of the Congress supersedes an earlier rule of international law or a provision of an international agreement as law of the United States if the purpose of the Act is to supersede the earlier rule or provision is clear or if the Act and the earlier rule or provision cannot be fairly reconciled.
44. “... In 1992 a bill (H.R. 5270) to reform the international tax rules was introduced for discussion purposes. The bill, which was not brought to a vote in either chamber, contained provisions that would have overridden tax treaties.” Gourevitch, supra note 40, at 184-32.
45. Id.
Today, it seems that the Treasury would rather see the U.S. negotiate new treaties or protocols than enact internal law provisions to pursue its goal of taxing income earned in triangular cases. On October 25, 1993, Leslie B. Samuel, Assistant Secretary of the Treasury, referring to the new Dutch treaty, said "[t]his treaty and protocol demonstrate that the treaty shopping problem can be addressed bilaterally and that unilateral action is unnecessary." This statement is particularly interesting for treaty countries, like Switzerland, that use the exemption method and whose tax treaty with the U.S. is currently being renegotiated.

V. CONSEQUENCES FOR U.S. TREATY PARTNERS USING THE EXEMPTION AS A RELIEF FROM DOUBLE TAXATION AND FOR THEIR DOMESTIC CORPORATIONS

A. For The Treaty Partners

In a triangular case such as described in the Dutch Protocol, the United States simply retains the ability to tax specific U.S. source income if this income is not sufficiently taxed abroad. The immediate conclusion for the treaty partner, or Country of Residence, is that it should tax for two reasons. First, whether the treaty partner likes it or not, a new tax base has appeared. The only question is which country will tax it. Altruism has no place in this field and the treaty partner will obviously tax rather than letting this source of revenue benefit the United States. Second, when a domestic corporation of the treaty partner approaches the 50% or 60% threshold, it is more favorable to pay the difference to the home country, rather than a flat 15% to the United States.

In order to limit the repercussions of the new U.S. policy on its domestic corporation, the treaty partner should make sure that the minimum tax required is met. The Country of Residence has two solutions in order to make sure that the threshold is met. First, it could apply a "conditional exemption" method, the condition for an exemption being a minimum aggregate tax rate corresponding to the minimum required by the United States. In example 2.2 above, assuming all income earned in the Country of Source is interest and royalties from U.S. sources, the Country of Residence would have to tax an extra 10,000 in order to reach the minimum tax required, and the taxpayer will incur a total tax liability of 60,000:

U.S. TAX TREATY POLICY

a. Tax rate in CR for a 200,000 income 40%
b. Minimum aggregate tax rate on the 100,000 earned in CS 20%
c. Minimum amount of tax to be paid on branch’s income 20,000
d. Less tax paid in CS (rate 10%) <10,000>
e. Extra tax to be paid in the CR 10,000
f. Total tax liability (10,000 in CS + 40,000 in CR + 10,000 “extra” in the CR) = 60,000
g. Aggregate tax rate on income earned in CS (10,000 in CS + 10,000 in CR)/100,000 = 20%

The second solution for the Country of Residence is to give up, at least partially, its exemption method and to adopt a “limited tax credit” method. The method would limit the credit to the U.S. source interest and royalties income earned by the branch. The coexistence of both tax credit and exemption methods is not unusual in itself. It is necessary, in fact, for countries that use the exemption method and sign an income tax treaty including an exemption of interest and royalties in the Country of Source. Without a tax credit method limited to such types of income, interest and royalties would be tax free in both the Country of Source, because of the treaty, and the Country of Residence, because of its exemption method. In this case, the tax credit is an alternative method of relief from double taxation when the taxpayer in the Country of Residence directly earns the interest and royalties from the Country of Source. In the triangular case, the U.S. policy imposes on its treaty partner a switch from one method to another when the taxpayer earns these types of income through a branch in a third jurisdiction.

By applying a “limited tax credit” method, as in example 2.2, the Country of Residence would tax the total income earned by the branch at a regular tax rate because we assumed it would be entirely U.S. source interest and royalties. The taxpayer would incur a total tax liability of 80,000:

a. Taxable income in CR 200,000
b. Tentative tax liability in CR (40% tax rate) 80,000
c. Less tax paid in CS <10,000>
d. Total liability in CR 70,000
e. Total tax liability is 10,000 in CS + 70,000 in CR = 80,000
f. Aggregate tax rate on income earned in CS 40%

48. OECD Model, supra note 4, art. 23A para. 2, at 346-65; see generally RIVIER, supra note 12, chapter 41.6 (describing the Swiss tax credit method as applied to interest and royalties).
For the domestic corporation, the “limited tax credit” method is worse because it generates taxation of U.S. source interest and royalties at the full corporate tax rate in the Country of Residence. On the other hand, the “conditional exemption” method in all cases limits the taxation of the U.S. interest and royalties to the rate necessary to avoid U.S. withholding.

The comparison of the tax burden on the branch’s income can be drawn whether the treaty partner adopts one of the above mentioned methods or does nothing. A tax burden of 25,000, or 25%, is due on the branch’s income if the treaty country does not tax (10,000 paid in the Country of Residence and 15,000 withheld in the United States). A 20% tax burden is due under the “conditional exemption” method, and 40% is due under the limited tax credit method. Consequently, if the source country is a “no-tax” country, the U.S. 15% withholding tax is always preferable for the corporation if the tax rate applicable in its home country is higher than 30%.

What happens if the treaty partner is bound by a tax treaty with the Third Country? No definite answer may be given because it depends upon the relevant provision of the treaty, concerning treaty renegotiation. Usually, without a treaty overriding practice in the Country of Residence, the treaty must be renegotiated.

B. For Their Domestic Corporations

In the following analysis, we will assume that U.S. source interest and royalties qualify for U.S. withholding under provisions similar to the present Dutch Protocol. We will then consider the effect of this framework on a corporation resident of the U.S. treaty partner in two financial situations. In the first scenario, the corporation has no taxable income in the Country of Residence. In the second scenario, the corporation is in the highest tax bracket in its Country of Residence. In both situations, we will consider whether the corporation should let the U.S. interest and royalties be earned by the branch in the Third Country, repatriate this type of income in the Country of Residence, or even transfer it to a Fourth Country. The answer depends upon the tax policy adopted in the Country of Residence after having signed a treaty or a protocol including a triangular case provision with the

49. This does not mean, for the purpose of the triangular case mechanism, that the applicable corporation tax rate equals zero. In fact, the applicable tax rate is determined not only by the income earned in the Country of Residence but also by the income earned in the Third Country, whether the Country of Residence applies the exemption method or the tax credit method.
United States.

1. The Country of Residence Keeps the Exemption Method with Progression as a Relief from Double Taxation

If the corporation has no taxable income in the Country of Residence, it has no tax liability even though the applicable tax rate is more than zero because of the income earned in the Third Country. In this case, the corporation should keep this source of income in the Third Country as long as the sum of the tax rate applicable in this country plus the 15% U.S. withholding is below the applicable tax rate in the Country of Residence; the same applies if the corporation is in the highest tax bracket in its home country.

If the aggregate U.S. and Third Country tax rate exceeds the applicable tax rate in the Country of Residence, then the corporation should consider repatriation to the Country of Residence. Repatriation must be examined carefully because it may have strong repercussions on the tax status of the corporation. Depending on the internal law of the Country of Residence, the corporation may lose a privileged “pure holding corporation” tax treatment because, for example, it would earn another type of income than just dividends. The corporation should also consider transferring the U.S. source income of the branch to a Fourth Country that has an income tax treaty with the U.S. limiting or suppressing the U.S. withholding tax rate.

2. The Country Of Residence Adopts the “Conditional Exemption” Method

This method guarantees to the corporation that its branch’s U.S. income will not be taxed at a rate higher than one-half of the applicable tax rate in the Country of Residence. Whether the corporation has any taxable income in the Country of Residence or is in the highest tax bracket, it is always advantageous to keep this income in the Third Country. Again, the corporation should consider transferring the income to a Fourth Country that has a tax treaty with the U.S.

3. The Country of Residence Adopts the “Limited Tax Credit” Method

The Limited Tax Credit Method suppresses the U.S. 15% withholding tax and taxes the U.S. interest and royalties at the full applicable rate in the Country of Residence. This solution is clearly the worst for the corporation unless the applicable tax rate in the Country of Residence is less than 15%. This might happen if the corporation has no taxable income in the Country of Residence before the inclusion of the branch’s income and if this income is not too high according to the scale applicable in the home country.

Because this method is based on the tax credit method, there is no
reason to move the U.S. source income from one country to another. Wherever such income is earned, it will be taxed in the Country of Residence unless it can be stripped out.

VI. CONCLUSION

The Triangular Case is a major new concern of the United States international tax policy. After an attempt in 1992 to introduce some internal law provisions unilaterally denying the benefit of tax treaties in such triangular cases, and disregarding the fact that the U.S. source income may be taxed in the Third Country, the United States negotiated a less extreme provision in the Dutch treaty.

There is no doubt that this policy will be expanded, either through a treaty-overriding provision in the Internal Revenue Code or through new treaties. Among all U.S. treaty partners, the next country that will have to negotiate a triangular case provision is certainly Switzerland. A new tax treaty between the United States and Switzerland is now being negotiated, and Switzerland, like the Netherlands, applies the exemption method as a relief from double taxation.

In a November 9, 1993 letter sent to the U.S. Treasury's international tax counsel, the Swiss-American Chamber of Commerce emphasized the importance of the business relationship between the two countries. Switzerland is the fourth largest recipient of U.S. direct investments abroad and ranks seventh among foreign direct investors in the United States. The Chamber of Commerce further emphasized the important tax matters that must be negotiated. In particular, referring to anti-treaty-shopping provisions, the Chamber of Commerce wrote the following:

We believe for treaty abuse provisions to effectively work in an increasingly complex business environment, it would be quite inappropriate if not presumptuous to seek to catch all situations which, from a purely formal viewpoint, may have a vague connotation of treaty abuse. Effective anti-abuse provisions must be simple and deal with the obvious.

The Triangular Case is not exactly a treaty shopping structure, but, from the point of view of the United States, it is nevertheless an abusive use of a treaty. Does it therefore deserve a special treatment as prescribed in the Dutch Protocol, or rather should the Triangular Case be ignored as having only "a vague connotation of treaty abuse"? We will let the negotiators answer this political question and content ourselves with tax planning recommendations to the foreign corpora-

50. Letter from Swiss-American Chamber of Commerce to Cynthia G. Beerbower (Nov. 9, 1993), reprinted in 93 TAX NOTES INT'L 228-10 (Nov. 29, 1993).
tions using a triangular structure for their U.S. interest and royalties income.